STATE STREET

Future Focused

Insights into Global ETFs Trends

As the ETF market exited 2020 with record-breaking flows exceeding US$760 billion[1], there were plenty of reasons for renewed optimism. Approved vaccines, capital stimulus, new market participants, the proliferation of products choices and more had global economies poised to re-open and bullish about the year ahead.

A Look Back at the 2021 Global Megatrends

Proving their resiliency as investment vehicles in periods of volatility, the ETF market took in an astounding US$1.3 trillion in net new flows, smashing the record established in 2020 by 70 percent[2].

Our experts take a look back at flow trends in 2021 and offer their outlook for what 2022 may have in store for the ETF market.

1. **Fixed-Income Allocations Lagged, but a Bullish Outlook Remains**
2. **ESG Growth Continued**
3. **ETFs Outpaced Long-Term Mutual Funds**
4. **Digital Assets Soared**

Fixed-Income Allocations Lagged, but a Bullish Outlook Remains

Fixed-income flows increased in 2020, but were a lower allocation to the overall ETF market in 2021. Still, this does not change our belief that the drivers behind increasing allocations will continue. The bond market expanded its universe of fixed-income securities and ETFs eligible for the US Depository Trust and Clearing Corporation (DTCC) continuous net settlement process. As the industry implements this change, the cost and risk of settlement will decline, providing an opportunity for lower bid-ask spreads in the secondary market to further modernize the bond market.

Although inflationary pressures, central bank interest rate increases and unwinding of asset purchases can create choppiness in equity markets and for fixed-income yields, the normalization of rates should positively impact fixed-income ETF flows over time. This, combined with aging populations who favor fixed income, provides a bullish environment for increased allocations.

ESG Growth Continued

Between 2020 and 2021, ESG ETFs nearly doubled in assets under management and flows[2]. Significant tailwinds persist for the continued expansion of passive and actively managed ESG ETFs including: the Sustainable Finance Disclosure Regulation (SFDR) implementation by the European Commission; the US Department of Labor's proposed rule to include ESG investments in retirement accounts; and the increased adoption of ESG across Asia Pacific (APAC). One major headwind we see is regarding uptake of ESG strategies from advisors and retail investors.

2021 proved to be another record-breaking year for European ETF growth, with the industry finishing the year at US$1.6 trillion in assets, representing more than 25 percent annualized growth over 2020[3].

A large element of the growth came from investment in ESG products with net inflows into ESG ETFs representing 51 percent of overall inflows into European ETFs in 2021[4].

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2021 proved to be another record-breaking year for European ETF growth, with the industry finishing the year at US$1.6 trillion in assets, representing more than 25 percent annualized growth over 2020.

ETFs Outpaced Long-Term Mutual Funds

As semi-transparent active funds and conversions from mutual funds to ETFs gain momentum, ETFs are outpacing long-term mutual funds in the US market. ETFs had a record-setting year with flows eclipsing 2020 by an astounding 88 percent[5]. Conversely, mutual funds had outflows in 2021.

Although APAC, Canada and Europe experienced record-breaking inflows to ETFs, each of its long-term mutual fund markets outpaced ETF growth. Still, we remain steadfast in our belief that ETFs will outpace mutual funds as the dominant investment wrapper globally as investors are exposed to its benefits, advisors migrate to fee-based advice, and regulators continue to eliminate retrocessions and embedded commissions.

Digital Assets Soared

One global trend that saw considerable attention during the year is the emergence of cryptocurrency. Although cryptocurrency ETF assets remain small at US$20 billion, they began the year at US$3 billion. Assets and flows only tell part of the story. Global regulatory approvals signal strong investor demand. It should be noted, the United States Securities and Exchange Commission has approved futures-backed Bitcoin ETFs, but has continued to reject applications for spot Bitcoin. Even so, the US market boasts the largest cryptocurrency ETF globally at close to US$1.5 billion in assets, even with the approval only occurring in October 2021[6].

What's in Store for 2022?

Europe

APAC

United States

Europe

Central Securities Depositary Regulation (CSDR) to Drive More Efficient Settlement Framework

After years of regulatory engagement, the settlement discipline framework of CSDR went live on 1 February 2022. The regulation initially proposed the implementation of mandatory buy-ins and cash penalties for settlement failures. However, after much industry consultation, the requirement for mandatory buy-ins has been postponed and only the cash penalty regime has been rolled out at this stage. The market is not ready for the mandatory buy-in model due to the lack of buy-in agents to offer solutions to all asset managers settling European equities in European depositaries. Postponement will be a positive development for ETF issuers, market makers and investors. Otherwise, it would have led to increased costs, and ultimately bid-ask spreads, to account for the impact of a mandatory buy-in regime.

There have been significant developments by depositaries, asset managers, market makers and service providers to implement capabilities for partial settlement and hold-and-release functionalities, which will aim to reduce the exposure to cash penalties due to settlement failures. This should lead to a more efficient settlement process across Europe.

We have closely evaluated the methodology of applying cash penalties to a fund's net asset value and whether management companies may take ownership of any negative impacts to performance. We're also running an industry working group focused on the impacts of CSDR and have identified a number of different solutions being implemented on the application of cash penalties depending on the asset manager and fund jurisdiction. With the regulation now live, we're analyzing the impact in areas such as spreads our clients have in the secondary market and the benefits of a more harmonized settlement framework.

ESG Will Continue to Accelerate

Inflows have been driven by a combination of regulation, such as SFDR, and a change in investment decisions across Europe. A significant portion of investment is coming from transfers out of mainstream ETFs with no ESG filter and an increase of new money into passive products. We saw a number of ETF issuers rebrand existing ETFs as ESG products, which required updating the fund's prospectus, amending the benchmark to ensure the fund is tracking an ESG-filtered benchmark and rebalancing the portfolio of assets to align to the ESG benchmark. A significant number of ETF launches were aligned to ESG benchmarks as opposed to mainstream indices. All of the large ETF issuers in the European market have launched new products focused specifically on Paris-Aligned and Climate Transition indices and this will continue into 2022 and beyond.

In 2022, we expect this trend of rebranding ETFs to align to ESG indices and launching new ETFs to track ESG indices will continue to grow. We're also anticipating a number of new asset managers to enter the European ETF market who have a strong track record with ESG strategies in traditional mutual funds and index trackers launches to track ESG ETFs. The majority of ESG ETFs have had a heavy focus on environmental factors such as climate and carbon reduction. But we anticipate an increasing focus on the social element of ESG as investors look for products that positively impact society.

Opportunity to Adjust the Model for Listed and Unlisted Share Classes

In our 2021 ETF Megatrends paper, we covered the potential for asset managers to create an ETF structure with listed and unlisted share classes, appealing to multiple investor types and leveraging the scale of an existing pool of assets. There is an appetite from asset managers in Europe to launch an ETF share class of an existing mutual fund, allowing the manager to operate an ETF without having to launch a whole new legal entity. However, the existing wording of the European Securities and Markets Authority guidelines requires the sub-fund to include 'ETF' in the naming even if there is only one ETF share class. While this was not the intention of the regulation, it, nevertheless, impacts an asset manager's ability to create such a structure off an existing mutual fund.

It is our belief the industry will re-engage with regulators such as Central Bank of Ireland on this topic in 2022 and such a model will be implemented in the future

APAC

Advisors Ready to Embrace Active ETFs and Crypto in Australia

Although the Australia ETF market is still dominated by passive products, active ETFs have seen and will continue to see significant growth based on the dual access model and the signaled entry of additional mutual fund managers to the market. Additionally, Australia is expected to launch its first cryptocurrency ETF in 2022 after the regulator released guidance for the launch of the new asset class. Based on the emerging demand for Bitcoin, Ethereum and other coins globally, the number of firms with filings to launch cryptocurrency ETFs and broader macro inflation concerns, we expect advisors and investors to embrace the products upon launch.

China ETF Stock Connect Will Add Product Diversity

The much anticipated ETF Stock Connect was approved between the Hong Kong and Mainland China stock markets. We expect this to increase the diversification of ETF products available to Chinese investors in a market dominated by domestic equity exposures. It also allows expanded access to Mainland China ETFs via the Hong Kong stock exchange. Additionally, Singapore and China signed a Memorandum of Understanding to establish an ETF link between the two country's exchanges to offer more cross-border investment options. We expect these schemes, in addition to earlier connections with the Japan and South Korea exchanges, to provide additional liquidity, enhance the capital markets and expand product choice across the exchanges.

Uncertainty Lingers as Japan / BOJ Eases ETF Purchases

Japan has been the largest market in the region from an asset and flow standpoint since 2010 when the Bank of Japan (BOJ) began purchasing ETFs as a component of its quantitative easing programs. For the first time since these purchases began, the BOJ changed course and reduced purchases in an attempt to tame inflation. This places a cloud of uncertainty considering the central bank has owned as much as 80 percent of the Japanese ETF assets. In fact, 2021 marked the first year Japan did not lead the APAC region in net new flows.

United States

Expect More Active Management Launches

Actively managed ETFs continue to be a key theme we expect to see in the year ahead, as more choices lure active managers into the market. The ETF Rule (6c-11), in effect since December 2019, has made launch and entry to the ETF market easier, less expensive and more flexible. Additionally, the ability to launch ETFs that have a periodic disclosure of fund holdings, limited to domestic equities to date, has expanded choice for asset managers concerned with the daily disclosure of its intellectual property. Finally, the ability to convert mutual funds to ETFs has created a new tailwind to actively managed ETF growth. Many asset management firms have signaled selectively using this approach to leverage scale and move assets to the investment wrapper deemed most attractive for the product strategy and distribution channel.

2022 Will Be About Targeting Customer Interest in ESG

If last year was about product creation, this year will be about expanding customer interest. ETF issuers are playing the long game, understanding the current flows are highly institutional in nature. The great wealth transfer from the older to younger generations is expected to increase investor allocations to ESG strategies. According to a 2021 Gallup survey, 58 percent of millennials are interested in ESG investing compared to one-third of Baby Boomers and Gen-X[7].

Thematic Investments Offer Even More Investor Choice

As the ETF marketplace has matured and less blank space exists for broad-based index, factor-based and sector ETFs, we've seen a pivot to the unpenetrated parts of the market, including passive and active thematic ETFs. Thematic ETFs include those focused on categories like disruptive technology, biomedicine, cybersecurity, work-from-home, etc. that allow investors to capitalize on key market trends. Assets under management for this component of the ETF market grew globally to US$437 billion in 2021, an increase of 20 percent from 2020[8]. Because the ETF Rule enabled quicker and less expensive launches, we expect the thematic trend will continue to grow as new and existing issuers look to capitalize on first-mover advantages.

What We're Watching in 2022

Will the US ETF market see its first new US$100 billion ETF manager since 2020?

Active ETFs are set to make up 70 percent of the new launches in the Canadian and US ETF markets

ESG ETFs will likely account for 70 percent of the flows in Europe

The first cryptocurrency ETF launch in APAC is likely to take place

Global active ETFs net inflows are poised to exceed US$200 billion

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